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BEFORE THE ARIZONA CORPORATION COMMISSION

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IN THE MATTER OF THE APPLICATION OF SOUTHWEST GAS CORPORATION FOR THE ESTABLISHMENT OF JUST AND REASONABLE RATES AND CHARGES DESIGNED TO REALIZE A REASONABLE RATE OF RETURN ON THE FAIR VALUE OF THE PROPERTIES OF SOUTHWEST GAS CORPORATION DEVOTED TO ITS OPERATIONS THROUGHOUT ARIZONA.

Docket No. G-01551A-07-0504

Arizona Corporation Commission
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RUCO'S REPLY BRIEF

The Residential Utility Consumer Office ("RUCO") offers this reply to the arguments offered by Southwest Gas Company ("SWG" or "Company") in its initial post-hearing brief. Many of the arguments presented by SWG were already addressed in RUCO's Initial Closing Brief, and will not be repeated here.

RATE DESIGN

Most of the arguments SWG offers in support of its proposed decoupling mechanisms (the RDAP, WNAP and the volumetric rate design) were addressed by RUCO in its initial brief. However, there are a few points SWG raises to which RUCO must respond. First, SWG argues that RUCO misunderstood the Company's volumetric rate design. SWG was also critical of what it alleges as RUCO's failure to explain why SWG's volumetric rate design is not revenue neutral, and why RUCO included the PGA adjustor in its chart. Company Brief at 13-14.

RUCO's position on these issues is straight forward – it is the Company that is creating confusion. The Company's witness, Brooks Congdon prepared a chart in response to RUCO's chart which compared the difference between the Company's volumetric rate design and a traditional average cost rate design. For each level of consumption considered, the Company's chart shows no difference in the cost between the Company's volumetric rate design and a traditional average cost rate design. A-24, Exhibit ABC-1. The Company's chart begs the question why the Company is proposing a volumetric rate design when there is absolutely no difference in the bottom line costs to ratepayers between the volumetric and the traditional rate designs. The answer is that the Company's analysis is obviously flawed. Contrary to what the Company claims, there is a difference between the two rate designs.

The Company's explanation fails to consider the actual estimated cost of gas that the Company's ratepayers will pay. Specifically, the Company's explanation fails to consider the difference between the pass-through gas costs to the company and the actual cost the Company is going to charge the ratepayer. Transcript at 315. This obvious miscalculation explains the flaw in the Company's argument. RUCO's witness, William Rigsby, explained in detail how RUCO's chart accounted for the Company's miscalculation by including a line item entitled "PGA Adjustor" in RUCO's exhibit (RUCO-1, Exhibit A). Transcript at 1314-1318. The Commission should reject the Company's volumetric rate design.

Second, the Company argues that it "is nothing less than shocking" that all of the parties have not embraced the Company's WNAP proposal. Company Brief at 15. The Company concludes that the only logical reason for the lack of support is the parties misunderstanding of how it operates. Id. According to the Company, the WNAP actually eliminates risk to the ratepayers. Id.

The Company explained the "mechanics" of the WNAP in its direct case:

> A "WNAP Volume Adjustment" will be calculated for each customer for each winter billing cycle to reflect the difference between the customer's actual use and usage assuming normal weather. The WNAP Volume Adjustment will then be used to calculate a "WNAP Dollar Adjustment" to each customer's billed delivery charge. A-24 at 7, Exhibit ABC-2.

There is no misunderstanding – ratepayers will be responsible for paying for a level of gas service that they will not use under the WNAP. The Company will be guaranteed to recover its margin which lowers the financial risk to the Company's shareholders. In response, the Company claims that the WNAP eliminates the risk to its customers because under the Company's current rate design customers are harmed during heating seasons that are colder than normal. Company Brief at 15. The flip side of course is that shareholders are harmed during seasons that are warmer than normal. Either way, when compared to traditional rate design where the shareholder bears the risks associated with weather, the WNAP shifts the risk to the customer – there is no way of getting around that fact.

The weather is a risk that shareholders of all utilities must face and must consider when investing in a utility. RUCO-8 at 12. Investors recognize that earnings can fluctuate as a result of the weather and that this type of risk is reflected in the utitlities' stock price and returns. Id. Since the WNAP reduces the risk by guaranteeing recovery of the margin, it necessarily follows that the Company's cost of equity should be reduced. RUCO-2 at 9. The Company has not made an adjustment to its cost of equity recommendation to reflect the reduction in risk. Id. The Company's WNAP proposal should be rejected.

Third, the Company highlights the different factors that drove the Company to propose revenue decoupling. Company Closing Brief at 17. Among those factors, the Company relied on the existing financial disincentive to promote conservation inherent in the current rate design. Company Brief at 18. Assuming that conservation is the reason for declining usage[1] there is merit to the Company's claim that the current rate design is a disincentive for the Company to promote conservation. The current rate design, which is a declining block design, is not unique to SWG. Many utilities have declining block rate designs and face the same disincentive to promote conservation. The solution to declining usage, however, does not require as extreme a measure as decoupling. RUCO's proposed solution of assigning a greater percentage of costs to the fixed charge is far less extreme and would provide the Company with adequate relief. Another possible solution, far more moderate than decoupling, would be to provide performance incentives tied to Demand Side Management funding. The Commission has pursued this approach with Arizona Public Service ("APS") and APS has responded very positively. Transcript at 686.

The Company next argues that when the Commission establishes rates, the rates are determined to be just and reasonable. Company Brief at 21. The Company claims that RDAP (and WNAP) hold customers harmless as they pay no more or less margin than what the Commission authorizes. Id. The Company concludes that since the Commission's determination assumes fair and reasonable rates, application of the decoupling mechanisms cannot harm customers. Id. This circular reasoning is flawed because it assumes that no matter what rates the Commission authorizes, the rates must be fair and reasonable. Rates that are based on the recovery of margins for gas service that customers do not use are not just, fair nor reasonable. The Commission should reject the Company's rate design proposals.

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[1] As previously stated, this assumption remains in dispute.

OPERATING EXPENSE OUTSTANDING ISSUES

RUCO OPERATING EXPENSE ADJUSTMENT No. 1 – ANNUALIZED LABOR AND LOADING EXPENSE.

RUCO incorporates its position set forth in its Closing Brief. RUCO maintains that the Company's request to annualize the 2008 wage increase is not appropriate because it goes too far beyond the test year. RUCO Brief at 9-10.

RUCO OPERATING EXPENSE ADJUSTMENT Nos. 6 AND 9 – UNNECESSARY MISCELLANEOUS EXPENSES AND EMPLOYEE RECOGNITION EXPENSES.

The Company claims that RUCO summarily concludes that all expenditures related to gifts and awards are inappropriate. Company Brief at 56. The Company's claim is incorrect. Like all cases that RUCO is involved in, RUCO submits data requests on utility expenditures and the Company provides RUCO with the requested information. RUCO's review of the journal entries submitted by the Company in response to RUCO's data requests resulted in numerous questions. RUCO-3 at 27. RUCO discussed the questionable entries with the Company and was able agree on the appropriate ratemaking treatment for some of the expenditures. For the rest, RUCO and the Company were not able to agree on the appropriate ratemaking treatment.

The Company complains that RUCO did not provide specific testimony or evidence of its analysis. Company Brief at 56. The Company's claim is again incorrect. RUCO did not present the actual invoices of each disputed journal entry. To have done so would have been burdensome, wasteful and unnecessary. RUCO did, however, categorize, itemize and provide the amounts of the different expenses that remain in dispute. RUCO-3 at 28. The Company then argues that its witness, Randi Aldridge, provided explanations which support its contention that the expenses in dispute are appropriate for inclusion. Company's Brief at 56. Nowhere has the Company explained, or can it explain, why massages and gift certificates to theatres, restaurants and shopping malls are necessary and/or appropriate for cost recovery from ratepayers. Likewise, while it may be more economical to hold meetings off-site, ratepayers should not have to pay for meetings held at lavish golf courses, resorts and spas. Ratepayers should not have to pay for employee massages, movie tickets and other similar types of expenses that are unnecessary and burden the cost of service.

RUCO OPERATING EXPENSE ADJUSTMENT No. 7 and 8 – EXECUTIVE COMPENSATION – MANAGEMENT INCENTIVE PROGRAM ("MIP") AND SUPPLEMENTAL EXECUTIVE RETIREMENT PROGRAM ("SERP")

RUCO and the Company propose fundamentally different approaches to determining whether certain labor expenses should be recovered from customers. SWG claims that the standard for recovery of the expenses of the Management Incentive Plan ("MIP") and the Supplemental Executive Retirement Plan ("SERP") is whether the overall compensation package of the affected employees is prudent and reasonable. Company Brief at 58. This argument is similar to the arguments the Company made in its last two rate cases. (Decision Nos. 64172 and 68487). In Decision No. 64172, however the Commission endorsed an approach to *evaluate specific components of employee compensation* to determine whether they are the type of expenses that customers should be funding.[2] In Decision No. 68487, the Commission recognized that the benefits of the plans cannot be precisely quantified, but there is little doubt that both the ratepayers and the shareholders derive some of the benefits of the incentives. Decision No, 68487 at 18. Here the Commission should, like it has done in the past, examine the individual MIP and SERP portions of the compensation package, not only

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[2] In Decision No. 64172, page 12, the Commission indicated: "Staff states that the issue is not whether the Company's overall compensation of its management is reasonable, as Southwest asserts, but rather whether ratepayers should be funding specific components of the MIP that encourages achieving shareholder goals." The Decision went on to adopt Staff's proposed allocation of MIP expenses. Thus, the Commission rejected SWG's approach of evaluating overall compensation, and examined an individual piece of compensation for appropriateness based on qualitative factors other than the amount of such compensation.

from a quantitative perspective (is the amount excessive?) but also from a qualitative perspective (is this an appropriate type of expense for customers to fund at all?). For the reasons discussed in its initial brief, RUCO believes that all of the SERP expense, and portions of the MIP expense, are not the sort of expenses that should be the responsibility of customers, regardless of the amount of overall compensation[3].

RUCO OPERATING EXPENSE ADJUSTMENT No. 12 - YUMA MANOR PIPE REPLACEMENT EXPENSE

RUCO incorporates its position set forth in its Closing Brief. Closing Brief at 12.

RUCO OPERATING EXPENSE ADJUSTMENT No. 13 – INCOME TAX EXPENSE

RUCO incorporates its position set forth in its Closing Brief. Closing Brief at 12.

COST OF CAPITAL

The Company complains that RUCO's recommended returns are "woefully inadequate" and contrary to the standards set forth by the United States Supreme Court in *Bluefield Waterworks & Improvement Co. v. Public Service Commission of West Virginia et al, 262 U.S. 679 (1923)* and *Federal Power Commission et al. v. Hope Natural Gas Co. City of Cleveland, 320 U.S. 591 (1944)*. SWG Br. at 25-27. The Company provides little support for its sweeping conclusion other than to note that RUCO's recommended cost of equity ("COE") is well below what this Commission authorized in the recent APS matter (10.75%) and is 206 basis points less than the 11.94% projected return for the Company's proxy group. Id. at 28-31.

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[3] The Company suggests that the Commission's decision can only rely on the record and cannot rely on its prior decisions. Company Brief at 2. This argument lacks merit. RUCO has testified in detail why the Commission should continue to follow in this case the precedent set in the last case. RUCO 3 at 29 – 31, RUCO 6 at 7-10. Moreover, in the hearing, the Judge took administrative notice of the Commission's decision in the Company's last rate case – Decision No. 68487. The record in this case supports the positions of both RUCO and Staff.

RUCO, in its initial brief, discusses at length how it arrived at its recommended return and why they are fair and consistent with the *Hope* and *Bluefield* decisions. RUCO recommends the Commission stand by its tried and true historical approach of determining a utility's COE by applying the discounted cash flow ("DCF") and/or the capital asset pricing model ("CAPM") equity estimation methodologies. There is nothing special about this case that warrants a change in the Commission's practice, which is clearly not as extreme as the Company proposes. The Company's proposal of taking the average COE calculation of the four methodologies the Company considered in its COE analysis has the intended effect of inflating the COE. The Company's DCF analysis places its intent beyond question. The Company arbitrarily drew the line on what it believed was the minimum COE it should consider among the companies it considered in its proxy, and eliminated from consideration any COE that was below this minimum. RUCO-7 at 54. The Commission should reject the Company's recommended COE.

RUCO's COE analysis, in addition to using both the DCF and CAPM models, also took into consideration the current outlook on the direction of interest rates, which are directly related to expectations regarding inflation in the economy. Id. at 35-46. Moreover, in determining its final recommended average cost of capital of 9.88%, RUCO adopted the Company's proposed hypothetical capital structure. RUCO-7 at 48. RUCO's recommended return on equity capital represents a balance of considerations, each analyzed with the notion of providing the Company with a reasonable rate of return, which is fair to the Company and fair to the ratepayers. The Commission should adopt RUCO's recommended rate of return of 8.83%.

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CONCLUSION

SWG's objections to RUCO's proposals regarding revenue requirements and rate design are all refuted in either RUCO's initial brief, or in this reply brief. The Commission should adopt RUCO's revenue requirement adjustments, and reject all of the Company's rate design proposals.

RESPECTFULLY SUBMITTED this 22nd day of August, 2008.

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